A Basic Guide to Contemporary Islamic Banking and Finance

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June 2000

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Preface

بِسمِ اللَّهِ الرَّحمَنِ الرَّحِيم

In the Name of Allāh, The Beneficent, The Merciful

I was asked by ISNA to produce a short guide to Islamic Banking and Finance for the Muslims of North America. To keep this guide short, we had to define our target audience rather carefully. This introductory guide is meant to address the Muslim who is familiar with the fundamental tenets and sources of legislation in Islam. The reader is not assumed to have elaborate prior knowledge of Islamic financial contracts, but a certain degree of financial sophistication will be required.

This is not a full survey of the field, and it is not a religious guide. It is the work of a single individual, who does not claim any religious authority beyond that which is derived from quoted texts. I tried my utmost to steer away from issues which are or may become controversial. Therefore, I have been careful to limit the discussion of recent *fatwās* and decisions of jurists and juristic councils. In that sense, this guide falls short of providing the reader with full information about "state of the art" Islamic financial instruments.

This apparent shortcoming is intentional. The field of contemporary Islamic finance is rather young, and marred by a number of shortcomings of its own. It is easy for an economist such as myself to fall prey to the temptation of claiming religious authority from translated texts and quoted opinions. It is also easy for specialized jurists to assume that they understand both the religious and the financial aspects pertaining to a specific contract or transaction. In both cases, there is a great danger for scholars of religion as well as students of economics and finance to speak falsely in the name of Islam.

I hope to succeed in minimizing this danger by speaking generally about the basic types of contracts used by "Islamic financial institutions" in North America and elsewhere. The generic forms of those contracts have been subjects of extended study by traditional jurists. My goal is to provide a concise summary of the nature of those contracts, and their Islamic foundations in Qur'ān, Ḥadīth, Sunnah, *'ijmā'*, and – where necessary – *qiyās*. The primary objective of this introductory guide is to explain to the non-specialist curious Muslim the difference between the forbidden financial transactions commonly used in conventional finance, and their Islamically permitted counterparts.

It is important for me to make it clear that I am not endorsing any particular institution or industry which labels itself "Islamic". There are many honest, sincere, and hardworking Muslim men and women who are currently struggling to make it easier for Muslims in North America to lead their lives in accordance with the *Sharī'ah*, without having to make unreasonable financial sacrifices. Such individuals and groups deserve our support and *du'ā'*. However, prudence also dictates that we recall that religion has often been used by individuals with sick hearts to exploit the gullible.

The humble educational aims of this work are two-fold:

1. By alerting the North American Muslims to the differences between conventional and Islamic finance, we may be able to boost the efforts of the sincere Muslims developing or dealing with Islamic financial institutions.

2. By providing a clear basic understanding of the underlying contracts, Muslims may become less prone to making inadvertent errors, as well as less likely to fall prey to the inevitable exploitative efforts of some unscrupulous individuals.

I beg the forgiveness of Allāh for the mistakes I make, and pray that He makes this effort a fruitful one.

Why "Islamic Finance"?

I would like to preempt two opposing reactions that many readers may have once they recognize that "Islamic finance" is in many ways very similar to (and at times identical with) conventional finance. Some may feel that this similarity is an attempt to dilute the Islamic teachings to simplify our lives, while others may feel that the Islamic Legal distinctions between Islamic and regular finance are artificial means of creating an industry where none is needed. I will be among the first to admit that the terms "Islamic banking" or "Islamic finance" can be quite misleading given the many similarities between Islamic and conventional financial contracts. To explain my point of view about this issue, let me use a good analogy: the issue of "Islamic marriage".

There are no obstacles that prevent Muslims in North America from having an Islamic marriage, a contract that adheres to the legal requirements of the state as well as the Islamic legal requirements. In certain respects, "a marriage is a marriage", but in other respects, to abide by all the requirements of the Islamic marriage contract, the Muslim man and woman need to do some extra work. Local Islamic centers, as well as continent-wide organizations like ISNA, provide information and contract-forms to help potential Muslim families abide by both sets of laws (e.g. providing local religious "marriage services", providing forms for an "Islamic will" to ensure abidance by Islamic inheritance laws, etc.).

Similarly, the notion that "a marriage is a marriage" may be applied in the realm of finance, e.g. "a lease is a lease". In this domain also, the Muslim needs to ensure that the contract he signs with the lessor or lessee agrees with the conditions of the lease contract (*'aqd al-'ijārah* or *'aqd al-'ījār*) in Islamic jurisprudence. Those conditions are put in place to ensure that the contract would not contain elements of *Ribā* or *G̱harar*, which are forbidden in Islam.

In this sense, "Islamic banks" or "Islamic financial institutions" try to ensure that all their contracts adhere to Islamic legal requirements as well as

state requirements. As with marriage, the outer form of an Islamic lease may seem to a casual observer to be identical to a regular lease. Recognizing the differences requires alertness to some of the legal requirements that may seem subtle to the casual observer. I hope that this primer will wet the readers' appetites to educate themselves regarding those important Legal financial requirements of Islam.

Abuses of the terms "Islamic banking and finance" in a number of Islamic countries have precipitated a degree of skepticism among the Muslim population. The view that the field consists of nothing more than mere nomenclature has become too deeply rooted in the minds of many sincere Muslims because of those abuses. That skepticism turned cynical when educated Muslims examined careless statements by early proponents of the field of Islamic banking in those countries. Those statements suggested that the differences between the Islamic model of finance and its conventional (western) counterpart should be obvious without any need for further education. Since the behavior of early Islamic banks seemed to casual observers to be very similar in function and form to conventional banks, the field was summarily dismissed as window-dressing.

Those early tactics were particularly ill-advised given the fact that Allāh (swt) did not deny the similarity between Islamic and conventional (or western) finance. When the Arabs argued that "trade is but like *ribā*" [2:275], Allāh (swt) did not deny that apparent similarity, but decisively informed that "but Allāh has permitted trade and forbidden *ribā*" [2:275]. The legal differences between the two are clear, and have been detailed over the centuries by capable Muslim jurists. However, the fact remains that the sophisticated Arab traders of Makkah did not at first see any discernible difference between the Islamic model and the one based on *ribā*.[1] Therefore, the reader seeking to understand this difference should expect that understanding the difference is a non-trivial process. My hope – as stated in the preface – is to dispel some of the misconceptions about this area, and encourage the reader to seek more requisite Islamic knowledge.

[1]Al-'Imām Al-Ṭabarī (1992, vol.3, p.104), Al-Qurṭubī (1996, vol.3-4, p.230) report in the exegesis of [2:275] that the Arabs before Islam knew only one type of *ribā*: Once a person's debt was due for payment, the creditor gave him the choice "either you pay, or you increase the debt". They argued that there is no difference between this type of increase and the increase in the price of a credit sale over the price of a cash sale is identical to what they were doing. However, Allāh (swt) made the fundamental distinction, which was later explained by the Prophet (pubh) and analyzed by Islamic scholars.

Contents

Chapter 1

Prohibitions of *Ribā* and *G̱harar*

It is commonplace in Islamic discourse to stress the positive injunctions to do good and forbid evil before discussing prohibitions and other negative injunctions. However, in the interest of saving the reader's time, we go directly to the need for having an "Islamic finance". In this regard, financial tools, like all other tools of social and economic interaction, can be used for good or for evil. Using the tools of finance for good rather than evil is – of course – of primary concern in the "Islamic" vs. "un-Islamic" distinction. However, those aspects of the distinction – important as they are – lie beyond the scope of this basic guide.

Our primary concern, instead, is the Muslim individual, group, or business, with a legitimate and good financial objective (e.g. purchase a home to house his family, purchase real estate to establish a *Masjid* or school, invest available funds in productive and permitted ways, etc.). As we shall see, many of the conventional financial tools currently available in North America (and most of the rest of the world) are legally prohibited in Islam. In this chapter, we shall review the two fundamental Islamic prohibitions which render financial contracts invalid (*bāṭil*) and forbidden (*ḥarām*).

Before proceedings to the specific prohibitions, I must reiterate that we are here concentrating on the Islamic legal aspects pertaining to the contract itself. Needless to say, an Islamically permissible contract may still be un-Islamic for other reasons. For instance, a legal contract for purchasing an automobile may be permissible, but the buyer may intend to use the car for evil rather than good. Concentrating on the legality of the sale contract does not imply that it is more important than the other considerations. It simply means that it is one important consideration.

1.1 The prohibition of *Ribā*

Most probably, the reader is familiar with the verses of prohibition of *Ribā* in the Qur'ān. Unfortunately, negligent interpretations of the meaning of those verses has led many individuals to assume that the prohibition only relates to situations where the creditor is likely to charge exploitatively high rates of interest. One of the most popular translations of the meaning of the Qur'ān, Yusuf ‘Ali (1991), translates the meaning of verses [2:278-279] thus:

> 278. O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are Indeed believers.
>
> 279. If ye do not, take notice of war from Allah and His Messenger: but if ye turn back, ye shall have your capital sums; Deal not unjustly, and ye shall not be dealt with unjustly.

Thus, the English reader who is not familiar with the end of verse 279 *“lā taẓlimūna wa lā tuẓlamūn”*, reads this translation as a proof that the (sole?) objective served by the prohibition of *Ribā* is the avoidance of injustice (in the sense of exploitation of the poor debtor by the rich creditor). However, the meaning of the ending of the verse – as explained by 'Abū Ja‘far, 'Ibn ‘Abbās, and others (c.f. Al-'Imām Al-Ṭabarī (1992, vol.3, pp.109-110)) – is much closer to: “if you turn back, then you should collect your principal, without inflicting or receiving injustice”. The exegetes (ibid.) then explain “without inflicting or receiving injustice” as “without increase or diminution”, where both an increase or a decrease of the amount returned relative to the amount lent would be considered injustice.

Understanding the Objectives of the Law is important for students of Islamic Law.[1] However, laymen and religious scholars alike must abide by the Law. Therefore, what we need to understand is: what constitutes the forbidden *Ribā*, and how can we avoid it? In the remainder of this section, we shall cite Ḥadīṯhs and jurists' analyses which explain the forbidden *Ribā*. Later chapters will deal with the Islamic alternatives to *Ribā*.

There are numerous Ḥadīṯhs which detail the prohibition of *Ribā*. In the interest of brevity, I list only two here:

[1]In this regard, Islamic scholars have long debunked the explanation of the prohibition of *Ribā* solely on the basis of its exploitative nature. The interested reader my refer to Al-Nawawī (continuation by Al-Subkī) (1995, vol.9: *“far‘ fī maḏhāhib al-‘ulamā' fī bayān ‘illat al-ribā fī al-'ajnās al-'arba‘ah”*).

1. Muslim narrated on the authority of 'Abū Sa'īd Al-Kh̲udriy; The Messenger of Allāh (pbuh) said:

   > "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt; like for like, hand to hand, in equal amounts; and any increase is *Ribā*."

2. Muslim narrated on the authority of 'Abū Sa'īd Al-Kh̲udriy:

   > Bilāl visited the Messenger of Allāh (pbuh) with some high quality dates, and the Prophet (pbuh) inquired about their source. Bilāl explained that he traded two volumes of lower quality dates for one volume of higher quality. The Messenger of Allāh (pbuh) said: "this is precisely the forbidden *Ribā*! Do not do this. Instead, sell the first type of dates, and use the proceeds to buy the other."

The first Ḥadīth̲ enumerates six goods which are eligible for *Ribā*. Since barter trading (e.g. dates for dates, as in the second Ḥadīth̲) is rarely of concern today, we shall mainly be concerned with *Ribā* as it pertains to gold and silver, the monies (Roman and Persian, respectively) used during the Prophet's (pbuh) time. With the exception of juristic schools which denied the use of reasoning by legal analogy (*qiyās*) as a source of legislation (e.g. the Ẓāhirīs), and a few contemporary detractors, most Islamic schools of jurisprudence accepted gold and silver in the first Ḥadīth̲ to signify money in general, including contemporary monies.[2] In this regard, the Islamic Fiqh Council of the Organization of Islamic Conference (OIC), in its third meeting in 1407 A.H., ruled as follows:

> After reading the studies presented to this Council regarding this topic, the Council has determined – regarding the legal status of paper currency – that it is a form of independent money, for which apply all the legal rulings which apply to gold and silver, including the rulings regarding *Ribā*, *Zakāh*, and *salam*. The legal reason for this ruling is the use of such monies as monetary numeraires, in terms of which prices are specified (*al-th̲maniyyah*).

[2] The interested reader may consult 'Ibn Rush̲d (1997, vol.3, pp.183-184) for a summary of the major Sunni school generalizations based on this Ḥadīth̲.

The first cited Ḥadīt̲h̲ makes it clear that there are two conditions for exchanging money for money: hand-to-hand, and in equal quantity. This is what is known as a currency exchange contract (*'aqd al-ṣarf*), where money is traded at the current exchange rate. However, any violation of the Ḥadīt̲h̲ will result in one of two forms of forbidden *Ribā*:

1. *Ribā al-faḍl:* where money is exchanged for money hand-to-hand, but in different quantities, or

2. *Ribā al-nasī'ah:* where money is exchanged for money with deferment.

The latter form (*Ribā al-nasī'ah*) is the one upon which most of western finance has been built. In the conventional financial sector, financial intermediation is effected through lending, and the time value of money is reflected in interest payments. As we have seen, this is unequivocal *Ribā*, the devourer of which was warned of a war from Allāh and His Apostle. Indeed, 'Abū Dāwūd narrated on the authority of 'Ibn Mas'ūd (mAbpwh) that

> The Messenger of Allāh (pbuh) cursed the one who devours *Ribā*, the one who pays it, the one who witnesses it, and the one who documents it.

Similar traditions with slightly different language were narrated in Muslim, Al-Buk̲h̲ārī, and Al-Tirmid̲h̲ī. Another most damning Ḥadīt̲h̲ was narrated by Ibn Mājah and Al-Ḥākim on the authority of 'Ibn Mas'ūd (mAbpwh) that the Prophet (pbuh) said:

> There are seventy three different types of *Ribā*, the least of which is equivalent [in sin] to committing incest, and the worst of which is equivalent [in sin] to destroying the honor of a Muslim.

Notice that unlike the prohibition of *G̲harar* (risky or ambiguous sales), to which we shall turn shortly, the prohibition of *Ribā* is unequivocal. The jurists have been more lenient to varying degrees with the prohibition of *G̲harar* since no contract can ever be totally devoid of uncertainty. However, as we shall see shortly, most of the financial needs that can be served with contracts containing *Ribā* can be met without the need for *Ribā*. In particular, Muslims do not need to deprive themselves of credit to avoid paying *Ribā*, nor do they need to forego the time value of their wealth to avoid receiving *Ribā*.[3]

[3]The notion that there is no time-value for wealth in Islam is false, as we shall see in Chapter 2. The notion that money is sterile (does not grow by itself) and has no time

1.1.1 Debt re-sale

As we shall see in the following chapter, Islamic financial contracts (e.g. leases and credit sales) result in debts or liabilities (*duyūn*) on the party for whom the acquisition of an asset is financed. Charging an increase for further deferment of the payment of such debts as a function of time (e.g. a late rental payment in a lease, or a late installment payment in a credit sale) would constitute *Ribā al-jāhiliyyah*, the worst form of *Ribā* condemned in the Qur'ān. 'Ibn Rus̲hd labeled such increases the rule of "defer and increase" (*'amhilnī 'azidka*) and condemned it thus. The opposite rule, in which the amount of the debt is reduced due to prepayment, was also listed by 'Ibn Rus̲hd (ibid.) among the types of *Ribā*, under the title "prepay and reduce" (*ḍa' wa ta'ajjal*). The prohibition of the latter rule has been controversial historically, and it was relaxed in recent years by various juristic bodies.[4] Those opinions were recently used to develop so-called "Islamic credit cards", where purchases are automatically financed over a fixed period (usually 12 months), and earlier payments result in reduced charges. Despite the almost unanimous acceptance of the juristic backing of this rule by contemporary juristic bodies, some of its various financial applications remain controversial.

The two rules discussed above can be encompassed under the more general topic of trading in debts. The "defer and increase" rule is in fact selling the current debt to the debtor, where the price is an even larger debt with a longer deferment period. As stated above, this is *Ribā al-jāhiliyyah*, and it is strictly prohibited. The sale of a debt to the debtor, therefore, must be at face value (unless part of the debt is forgiven).

More interesting, on the other hand, is the potential of selling debts to third parties. In conventional "asset-backed securitization", a mortgage company or bank sells its "accounts receivable" from its mortgages or other

value is – in fact – part of the traditional doctrine of the Catholic church, and rather alien to Islam. In fact, it was argued in Al-Qaraḍāwī (1999, vol.1, pp.37-8, 139-149) that the growth potential (*namā'*) for wealth (*māl*) is one of the conditions of eligibility for *Zakāh*. The term is derived from *zakā* which means "to grow". The word *Ribā* is derived from *rabā* which also means "to grow". The reader is encouraged to contemplate the constant conjunction of Qur'anic verses of the prohibition of *Ribā* with verses encouraging charitable payments.

[4] See, for instance, the recent rulings by مَجمَع الفِقه الإِسلَامِي, اَلمَصرَف الإِسلَامِي الدَولِي لِلإِستِثمَار وَ التَنمِيَة, شَرِكَة الرَاجِحِي, and بَيت التَموِيل الكُوَيتِي (c.f., resp., Sakhr (1996, fatawa #50,1291,265,740,536).

financing instruments to third parties. In fact, if the reader currently has a mortgage with any given company, it is almost certain that this mortgage was securitized and sold to others (e.g. Fannie Mae, etc.), even though payments continue to be made to the originator mortgage company.

The reason I mention this issue will become apparent in Chapter 3 below. Islamic banks will have "accounts receivable"[5] corresponding to lease or installment payments (in leases and credit sales, resp.). In principle, those accounts receivable may be "sold" to the public as a fixed-income investment vehicle with minimal risk (the risk that the debtor will default, and the repossessed asset sells for less than anticipated). Debt re-sale has been used extensively in the Islamic financial market in Malaysia, following a S̱hāfi'ī ruling which permits such trading. The practice remains controversial since the Ḥanafīs and Ḥanbalīs (with the exception of 'Ibn Al-Qayyim) render such transactions prohibited, and the Mālikīs permit it only under very stringent conditions. While a variety of "tricks" (*ḥiyal*) under various guises have been suggested and used in various "Islamic countries", I shall restrict attention in Chapter 3 to the most obviously uncontroversial alternatives which do not include such tricks.

1.2 The Prohibition of *G̱harar*

There are numerous Ḥadīt̲h̲s forbidding *G̱harar* sales, and specific instances thereof. One commonly cited Ḥadīt̲h̲ was narrated by Muslim, 'Aḥmad, 'Abū Dāwūd, Al-Tirmid̲h̲ī, Al-Nasā'ī, Al-Darāmī and 'Ibn Mājah on the authority of 'Abū Hurayra (mAbpwh) (translation of the version in Muslim) that

> The Prophet (pbuh) prohibited the pebble sale and the *G̱harar* sale.

A good translation of *G̱harar* is "risk" or "uncertainty".[6] Professor Muṣṭafā Al-Zarqā' defined it as follows:

[5]An "account receivable" is any amount owed to a business by a customer as a result of a credit sale.

[6]The term risk (Italian: *risco*, French: *risque*) is derived from the Latin roots *re* = back and *secare* = cut, thus reflecting the potential for a sailor to have his ship cut by hitting a rock. In other words, "risk" means "danger of loss". This is precisely the meaning of the Arabic term *G̱harar*. The literal meaning of the term *G̱harar* according to Qāḍī 'Iyāḍ (c.f. Al-Qarāfī (n.d., vol.3, p.266)) is: "that which has a pleasant appearance and a hated essence".

> *G̱harar* is the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling.

Many classical examples of *G̱harar* were provided explicitly in the Ḥadīt̲h. They include the sale of fish in the sea, birds in the sky, an unborn calf in its mother's womb, a runaway animal, the semen and unfertilized eggs of camels, un-ripened fruits on the tree, etc. All such cases involve the sale of an item which may or may not exist. In such circumstances, to mention but a few, the fish in the sea may never be caught, the calf may be still-born, and the fruits may never ripen. In all such cases, it is in the best interest of the trading parties to be very specific about what is being sold and for what price. For instance, 'Aḥmad and 'Ibn Mājah narrated on the authority of 'Abū-Sa'īd Al-K̲hudriy (mAbpwh):

> The Prophet (pbuh) has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver.

The last prohibition in this Ḥadīt̲h pertains to a person paying a fixed price for whatever a diver may catch on his next dive. In this case, he does not know what he is paying for. On the other hand, paying a fixed price to hire the diver for a fixed period of time (where whatever he catches belongs to the buyer) is permitted. In this case the object of sale (the diver's labor for – say – one hour) is well defined. In many cases, *G̱harar* can be eliminated from contracts by carefully stating the object of sale and the price to eliminate unnecessary ambiguities.

In contemporary financial transactions, the two areas where *G̱harar* most profoundly affects common practice are insurance and financial derivatives. Jurists often argue against the financial insurance contract, where premia are paid regularly to the insurance company, and the insured receives compensation for any insured losses in the event of a loss. In this case, the jurists argue that the insured may collect a large sum of money after paying only one monthly premium. On the other hand, the insured may also make many monthly payments without ever collecting any money from the insurance company. Since "insurance" or "security" itself cannot be considered an object of sale (c.f. Al-Zuḥaylī (1997, vol.5, pp.3415-3420) for more details), this

contract is rendered invalid because of the forbidden *G̱harar*. Of course, conventional insurance also suffers from prohibition due to *Ribā* since insurance companies tend to invest significant portions of their funds in government bonds which earn them *Ribā*.

The other set of relevant contracts which are rendered invalid because of *G̱harar* are forwards, futures, options, and other derivative securities. Forwards and futures involve *G̱harar* since the object of the sale may not exist at the time the trade is to be executed. As we are going to see, Islamic Law permits certain exceptions to this rule through the contracts of *salam* and *'istiṣnā'*. However, the conditions of those contracts make it very clear that contemporary forwards and futures are not permitted under Islamic law. Classical jurists called such contracts where both the price and the goods were to be delivered at a future date *al-bay' al-muḍāf*, e.g. "I sell you this car for so-much at the beginning of the next month", and considered them non-concluded and thus invalid. Contemporary options were also discussed by traditional jurists, e.g. "I sell you my house for so-much if my father returns", and called it a suspended conditional sale (*al-bay' al-mu'allaq*). They have also rendered such sales invalid due to *G̱harar* (c.f. *Al-G̱harar wa 'Atẖaruhu fī Al-'Uqūd* by Ṣiddīq Al-'Amīn (pp.137-149) for a full discussion).

1.3 Obeying the Law

I hope that the reader will find that the questions which justify the development of an "Islamic financial" industry are well motivated:

1. If a Muslim does not possess enough cash to purchase a house, car, office equipment, etc., does he have any options other than borrowing to finance such a purchase (which will no-doubt include *Ribā*), or refraining from making the purchase (which will no-doubt affect his quality of life and future financial prospects)?

2. Can a Muslim (perhaps a retiree) invest his savings in a way which will earn him a *ḥalāl* income without exposing himself to too much risk?

3. Is there a permissible alternative to commercial insurance?

Chapter 2

Permissible Financing Methods

Most types of trade (buying and selling) are permitted in Islam, where prohibition is the notable exception. Yusuf ‘Ali (1991) translated the meaning of [2:275] thus:[1]

> Those who devour usury (*ribā*) will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say: ‘trade is like usury’, but Allāh hath permitted trade and forbidden usury.

Thus, “Allāh has permitted trade” (*bay‘*) is the general rule, with *Ribā sales* being a strictly forbidden exception.

A valid trade is concluded in Islam if the seller and buyer exchange an offer and acceptance which specify the object of sale and the price, and they both agree. Yusuf ‘Ali (1991) translates the meaning of [4:29] thus:

> But let there be among you traffic and trade by mutual good will.

Al-Bayhaqī and ’Ibn Mājah narrated on the authority of ’Abū-Sa‘īd Al-Khudriy that the Messenger of Allāh (pbuh) said (translation of the language in ’Ibn Mājah):

> I shall meet Allāh before I give anyone something owned by another without his consent, for a trade requires mutual consent.

[1]The English reader may take the term “usury” to mean exorbitant interest, as most contemporary dictionaries would indicate. As seen in the previous chapter, *Ribā* (a term for which no contemporary English translation would be accurate) is strictly forbidden regardless of how small or large the interest rate may be.

Not only is trading permitted, it is encouraged. Al-Suyūṭī mentioned in *Al-Jāmi' Al-Ṣaghīr*, a Ḥadīth on the authority of Rāfi' that:

> The Prophet (pbuh) was asked: "which are the best forms of income generation?" He (pbuh) replied: "A man's labor, and every legitimate sale".

Therefore, any financing conducted through valid trading by mutual consent is permissible. However, since most Muslims (myself included) lack sufficient knowledge regarding the various conditions for a sale to be valid, contemporary jurists and financial practitioners have limited Islamic banking and finance to a few "named" contracts. Those are contracts that have been studied extensively by jurists over the centuries, and whose validity is well established through the Prophet's (pbuh) own actions (*Sunnah*), or consensus of the early Muslim communities and jurists (*'ijmā'*). To further add credibility to the industry, the Arabic names for those contracts are often used instead of their English counterparts (e.g. the term *'ijārah* is often used instead of its English counterpart "lease"). In what follows, I shall review the most commonly used contracts in Islamic finance, utilizing both their Arabic and English names.

2.1 Cost-plus sales (*murābaḥa*)

In this sale, the buyer knows the price at which the seller obtained the object to be financed, and agrees to pay a premium over that initial price. It was narrated that 'Ibn Mas'ūd (mAbpwh) ruled that there was no harm in declared lump-sum or percentage profit margins. Thus, one may approach an Islamic financial institution and say "purchase this item on my behalf at this price, and I shall give you a profit (*'urbiḥuka*) margin of $10", or "purchase this item on my behalf at this price, and I shall give you a profit (*'urbiḥuka*) margin of 10%". The fact that the latter statement may be perceived to make explicit a percentage[2] payment should not be of concern, since it is not *Ribā* if the sale satisfies the conditions of *murābaḥa*.[3] Notice that in this

[2]Or "interest rate", if a time factor is present as we shall see in the next section.

[3]The faulty use of the contemporary term "interest" as a translation of the term *Ribā* has led to many misconceptions. Bank interest is certainly the forbidden *Ribā* (please see the long discussion of this point in Section 5.2 below). However, just because a profit margin in a valid sale is stated as a percentage does not mean that it is *Ribā*. Stating

contract, the Islamic bank or financial institution must own the item at the time the customer buys it from them with the specified profit margin.

2.2 Credit sales (*bay‘ bi-t̲haman ’ājil*)

Very rarely is *murābaḥa* used by Islamic banks with the price paid immediately by the customer. In such cases, there would be no financing included, and the Islamic bank would simply be a middle-man or broker-agent (*simsār*). When a customer approaches an Islamic bank to finance a purchase through *murābaḥa* the payment of the price is usually deferred, and most commonly paid in installments.[4]

In such cases, it is easy to look at the end result and assume that this is simply a juristic "trick" to circumvent the prohibition of *Ribā*. However, this is certainly not the case. Indeed, the *murābaḥa* component determines a profit margin (even as a percentage of the original price), and the deferment ensures that this profit is collected over a period of time. The rate of return is thus guaranteed (up to the risk of default on payments by the buyer) over a fixed period of time. Twenty-some year-old misconceptions in the literature on Islamic banking would argue that this makes the banks' profits a form of *Ribā*. However, it is curious to note that some of the proponents of this view in the 1970s were themselves the pioneers of the field of Islamic banking in the Arab Islamic countries and elsewhere. Those banks dealt almost exclusively in the early years in instruments such as the one considered here (and leases to which we shall turn shortly). It was only a matter of time for sophisticated observers to note that those banks' rhetoric contradicted their actions. This early confusion about Islamic banking and finance continues to plague the immigrant Muslim community in North America to this day.

Perhaps the source of the confusion is precipitated by the conjunction of the deferment of the price payment and the profit rate. A seventh grader can calculate the implicit annual interest rate in such a contract. However, traditional Islamic jurists over the centuries have indeed permitted such a conjunction of increase with deferment. In fact, they have explicitly justified

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it as a percentage only requires simple division of the profit margin by the original price, followed by multiplication by 100! In fact Jordanian law on *murābaḥa*, dating back to Ottoman Law in 1903, explicitly states a maximal interest rate of 9% in *murābaḥa*.

[4]For Arabic readers, I recommend the excellent short manuscript by Al-Miṣrī (1997) for all the relevant juristic details of the permission of such sales.

the increase by the deferment. Al-Miṣrī (1997, pp.39-44) lists a number of quotes by traditional jurists of various schools, illustrating the permissibility of increasing the price based on deferment. Some jurists qualified this permissibility with conditions to ensure that other reasons for prohibition (e.g. two sales in one, a sale and a condition in one contract, etc.) were not present.

I shall only list a few of the quotations included in the above text to illustrate that increasing the price due to deferment is indeed permissible:

- Al-Kāsānī in *Badā'i' Al-Ṣanā'i'* (Ḥanafī masterpiece) said: "the price may be increased based on deferment" (اَلثَّمَنُ قَد يُزَادُ لِمَكَانِ الأَجَل).
- *Ḥāshiyat* 'Ibn 'Abidīn (compendium of Ḥanafī jurisprudence): "a price is increased if it is deferred" (يُزَادُ فِي الثَّمَنِ لِأَجْلِهِ).
- 'Ibn Rushd (Mālikī) in *Bidāyat Al-Mujtahid wa Nihāyat Al-Muqtaṣid*: "He has given time a share in the price" (جَعَلَ لِلزَّمَانِ مِقْدَارًا مِنَ الثَّمَنِ).
- In *Al-Majmū'* by Al-'Imām Al-Nawawī and Taqiyuddīn Al-Subkī (Shāfi'ī masterpiece): "deferment earns a portion of the price", also in *Ḥāshiyat El-Gamal 'alā Sharḥ Al-Manhaj* (Shāfi'ī), and *Fatāwā* 'Ibn Taymiya (Ḥanbalī), (اَلأَجَلُ يَأْخُذُ جُزءًا مِنَ الثَّمَنِ).

The contemporary confusion is hardly new. In 'Ibn Al-'Arabī's *'Aḥkām Al-Qur'ān*, he reports a specific argument given by the Arabs during the time of Prophet Muḥammad (pbuh) to support their statement that "trade is like *Ribā*" [2:275]. They argued as follows: Consider a credit sale, with a price of 10 payable in a month. After a month, the buyer and seller agree to postpone for one more month, and increase the price to 11. The latter is forbidden *Ribā*. They then argued: is this not the same as an initial sale with the price of 11 deferred for two months? The answer in [2:275] was a decisive "but Allāh has permitted trade and forbidden *Ribā*".

The legal difference between the two is very clear: one is a sale in which price is increased for deferment, and the other is an increase in the amount of a debt for deferment. The first is permitted, and meets almost all the financing needs which can be met through forbidden *Ribā*-based lending. The second, however, is strictly forbidden. The permissibility of the first and the

prohibition of the second are both quite clear and unequivocal.[5] Therefore, we may use credit sales as a form of finance, and we must categorically avoid interest-bearing loans. Why one is permitted while the other is forbidden can only be fully known by Allāh and whomsoever he gave such knowledge. As a practical matter, we should know what is permitted and use it to our advantage, and what is forbidden and avoid it.

2.3 Leasing (*'ijārah* or *'ījār*)

Legally, the lease contract is not a sale of the object, but rather a sale of the *usufruct* (the right to use the object) for a specified period of time. The sale of usufruct is permissible in Islam, as evidenced by the verses (translation of meaning by Yusuf Ali (1991)):

> And if they suckle your offspring, give them their recompense. [65:6]
>
> Said one of them: 'O father, hire him on wages, for truly the best to employ is a strong and trustworthy man'. He said: 'I intend to wed one of my daughters to you, on condition that you work for me for eight years, and if you complete ten full years, that will be a grace from you'. [28:26-27]

It is also established by the following Ḥadīṯh narrated by 'Aḥmad, 'Abū Dāwūd, and Al-Nasā'ī on the authority of Sa'd (mAbpwh):

> The farmers during the time of the Prophet (pbuh) used to pay rent for the land in water and seeds. He (pbuh) forbade them from doing that, and ordered them to use gold and silver (money) to pay the rent.

Also, 'Aḥmad, Al-Bukẖārī and Muslim narrated on the authority of 'Ibn 'Abbas (mAbpwh) that the Prophet (pbuh) hired a man to cup [water] for him, and paid him his wages.

There are a number of conditions for lease-financing to be valid (the interested reader may refer to M. Taqi Usmani (1998, pp. 157-174) for a partial

[5] The non-Arabic readers, who may not have access to the above referenced manuscript by Al-Miṣrī (1997), may refer to M. Taqi Usmani (1998, pp.104-109) for clear legal distinctions between the increased price in credit sales and the forbidden interest on loans/debts, as well as some of the technical legal conditions for *murābaḥa* financing to be valid.

list). The most important financial difference between Islamically permitted leasing and conventional financial leasing is that the leasing agency must own the leased object for the duration of the lease. Therefore, while leasing an automobile from a car manufacturer or dealership may in principle be permitted (if the contract satisfies the other conditions), Muslims should be careful. In many cases, the dealership will in-fact use a bank or other financial intermediary to provide a loan for the present value of lease payments, and charge the customer an interest on this loan. This would constitute the forbidden *Ribā*. Careful Islamic financial institutions ensure that the contract abides by all the restrictions set in the *S̲harī'a* (e.g. sub-leasing requires the permission of the lessor, late payment penalties must be handled very carefully to avoid the forbidden *Ribā*, etc.).

Recently, Muslim jurists have also provided an Islamic alternative to conventional lease-purchase agreements (called in Arabic *'ijārah wa 'iqtinā'*). In this contract, a lease is written as discussed above, with an additional promise by the lessor that he will agree to sell the leased object at the end of the lease at a pre-determined residual value. This promise is binding on the lessor only, and the lessee has the option of purchasing the item at the end of the lease, or returning it to the owner-lessor (c.f. ibid. (pp.175-6)).

A common model for equipment, auto and home financing in North America is based on leasing or lease-purchase. The Islamic financial institution buys the financed object, and retains the title through the life of the contract. The customer makes a series of lease payments over a specified period of time, and may have the option at the end to buy the item from the lessor (and owner) at a pre-specified residual value. The period of the lease and the rent payments may be made such that the final payment is only symbolic.

It is no secret (at least it should not be a secret) that the Islamic bank or financial institution will take into consideration the same factors when determining the rental payments and residual value that a regular bank would consider: the value of the financed item, its depreciation value, inflation, the credit-worthiness of the lessee, the opportunity-cost value of the money (as reflected by market interest rates), etc. Of course, an implicit "interest rate" can trivially be calculated from the price, residual value, term of the lease and the lease payment. There is no need to hide this fact, and indeed, the intelligent Muslim customer (as Muslim customers should always be) must be encouraged to "shop-around" and ensure that the Islamic financial institution is not implicitly charging an interest rate which is not in line with the conventional market. However, in the final analysis, the difference will

be in the form of the contract. If the lease is structured in accordance with the various conditions detailed in books of jurisprudence, it will contain no *Ribā* and will ensure that it cannot contain such forbidden *Ribā* in the future (e.g. in terms of late payment fees, etc.).

2.4 Partnerships (*mus̲hāraka* and *muḍāraba*)

Various forms of partnership can be direct financing methods. In the early days of Islamic banking and finance, those forms were commonly grouped under the banner "profit and loss sharing", to be contrasted with the above listed debt-based forms of financing. It was assumed by some that the profit and loss sharing methods were somehow more ideal from an Islamic point of view. The fact that most Islamic banking practice concentrated on credit sales and leases was thus often lamented as re-labeling of the forbidden interest. As we have already seen, if the Islamic banks and financial institutions are careful to abide by the rules of *S̲harī'a*, there is no reason to think that credit sales are any "less Islamic" than a silent partnership (*muḍāraba*) or full partnership (*mus̲hāraka*).[6] There are a number of rules in *S̲harī'ah* regarding the language of the various partnership contracts, the rights and obligations of various parties, and the sharing rules for profits and losses.

Most of the users of such partnership contracts will require the services of legal experts in any case, and therefore should also consult Islamic legal experts on the legitimacy of any specific contract. Therefore, there is no need to spend much time on those general contracts.

However, one model of financing which has been used in North America is

[6]Still, respected jurists as well as many Islamic economists, while admitting the permissibility of debt-based financing, continue to echo such sentiments. For instance, M. Taqi Usmani (1998, pp.239-240) states: "The ideal instrument of financing according to the Shariah is Musharakah where the profits and losses both are shared by both the parties according to equitable proportions". This opinion is not based on any solid juristic or religious evidence, but rather based on the jurist's economic reasoning (ibid): "Musharakah provides better opportunities for the depositors to share actual profits earned by the business which in normal cases may be much higher than the rate of interest. Since the profits cannot be determined unless the relevant commodities are completely sold, the profits paid to depositors cannot be added to the cost of production, therefore, unlike the interest-based system the amount paid to depositors cannot be claimed back through increase in the prices". It is important for the sophisticated reader to distinguish between the jurists' opinions which are based on solid religious grounds, and those based on inadequate economic reasoning.

based on a form of *mus̱hāraka*, where the financing agency and the customer share the ownership of real estate. This contract is known by many names, most prominent among them is the name *mus̱hāraka mutanāqiṣah* (diminishing partnership). In contrast to the leasing model, where ownership of the financed item remains with the lessor for the entire lease period, ownership in a diminishing partnership is explicitly shared between the customer and the Islamic financial institution (legally, what is established is an Islamic *s̱harikat al-milk*). The periodic payments of the customer in this model contain two parts: (i) a rental payment for the part of the property owned by the Islamic financial institution, and (ii) a buy-out of part of that ownership. Over time, the portion of the asset which is owned by the customer increases, until he owns the entire asset and needs to pay no more rent. At that time, the contract is terminated.

Examining the periodic payments, the customer will find that they look very much like a conventional mortgage schedule. Early-on, a large portion of the payment is "rent" (corresponding to "interest payment" in conventional mortgage), and a small part is "buy-out" (corresponding to the "principal payment" in a conventional mortgage). As time progresses, the first component gets smaller, and the latter component gets bigger, until the rent becomes zero when the customer owns 100% of the asset. Given this one-to-one correspondence between the two components of the payments, it is again trivial to calculate the equivalent interest rate which would make the conventional mortgage payments identical with the diminishing partnership payments.

Again, this should not be cause for concern, as long as the partnership contract is written in full accordance with the rules of *S̱harī'a* (for a partial list and general discussion, see M. Taqi Usmani (1998, pp. 31-92)). For instance, there is a fundamental difference between a mortgage company which holds a lien on a financed house, and the actual joint ownership of the house between the client and the Islamic financial institution. There are a variety of issues which such institutions need to resolve to operate in compliance with *S̱harī'a* as well as government regulations, and the intelligent Muslim customer is again encouraged to ensure that both sets of regulations are met. As for the correspondence of the "rental" portion of payments to what would be an interest payment on the principal balance in a conventional mortgage, this should afford the intelligent Muslim customer an opportunity to ensure that he is not being charged excessively relative to the conventional market. As far as compliance with the Islamic *S̱harī'a* is concerned, the form of the

contract is what matters. To keep the Islamic financial industry from reeping excessive profits at the expense of devout Muslims with few alternative sources of financing, this comparison to conventional market trends is very valuable.

2.5 Islamic forwards (*salam* and *'istiṣnā‘*)

Those forms of financing are very rarely used, and hence will be mentioned only in passing. In general, the sale of non-existent objects is forbidden due to *G̱harar*. However, to facilitate certain types of business, exceptions were given through those two contracts. The six major books of Ḥadīṯẖ narrate on the authority of 'Ibn ‘Abbās (mAbpwh):

> The Messenger of Allāh (pbuh) came to Madīnah, and found its inhabitants entering *salam* contracts (with the price paid in advance) in fruits for one, two, and three years. He (pbuh) said: "whoever enters into a *salam* contract, let him specify a known volume or weight, and a known term of deferment".

Thus, he (pbuh) permitted this trade, where the price is paid in full, and the well-defined object of the sale is delivered after a specified time. This pre-payment of the price allowed the farmers to buy seeds, spend for their own sustenance, etc., in order to be able to produce the fruits.

Most jurists reasoned by analogy (*qiyās*) and preference (*'istiḥsān*) from the permissibility of *salam* to the permissibility of *'istṣnā‘*, which may be translated as "commission to manufacture". In the latter contract, the price is paid in installments as the work progresses in manufacturing or building an otherwise non-existent object. The price pre-paid in installments in this case will often be lower than the cost of purchasing the finished product (if it were to exist), and can therefore be a useful tool for building schools, *Masjids*, etc.

Those two contracts are permitted as exceptions to the general rules of sale. As such, there are **many** conditions which must be met for *salam* or 'istiṣnā‘ contracts to be valid. Those considering the use of such contracts are advised to consult an Islamic Legal expert along with their other lawyers to ensure that they abide by *S̱harī‘a* as well as government regulations.

Chapter 3

Permissible Investment Vehicles

The previous chapter dealt with permissible vehicles that would allow Muslims to acquire capital to finance purchases of equipment, homes, automobiles, etc. We now turn to the other side of the coin: what permissible investment vehicles are available for Muslims? Of course, there are many direct investment vehicles. A Muslim can invest directly in any legitimate business, possibly earning some profits. However, it is useful to focus on relatively passive investment vehicles such as equities, mutual funds, etc., as well as "fixed-income" alternatives to forbidden interest-based instruments such as bonds and money-market funds.

3.1 Investing in equities

Common shares in a listed company are – as the name suggests – "shares" in the assets of the company. Thus, if the company's business is legitimate, and its conduct is in compliance with the rules of *S̲harī'a*, Muslims are allowed to own such common shares (stock). Common stock may thus be bought and sold, as the potential owner sees fit. While the common stock is held, it earns a portion of the total profits of the firm, part of which may be distributed to the shareholders in the form of dividends, and the other part may be reinvested in the company. Thus, the first part of the profit-share is given directly to the shareholder, while the second part is given back implicitly by the increase in the company's capital, a fixed proportion of

which is claimed by the held share. Other common means of investing in claims on companies' capital are not allowed: bonds are explicitly a claim on a portion of the company's interest-bearing debt, and preferred stock are a hybrid stock/bond.

Since common stocks of Islamically appropriate companies may thus be bought and sold, it is also possible to create mutual funds in such stocks. A mutual fund would group the funds of a number of investors, and "manage" those funds by investing in a portfolio of permitted stocks, buying and selling them as they see fit. The mutual fund managers collect a fee for their efforts in studying the market conditions as well as the prospects of each given company. In some Islamic countries, some "Islamic mutual funds" also calculate and pay the appropriate *Zakāh* on shares on behalf of their investors, in addition to screening the various stocks and choosing the portfolio weights according to their best judgment. Within the Islamically permitted pool of companies approved for trading by the *S̲harī'ah* boards of such fund-managing companies, a variety of funds may be created (technology, high-growth, blue-chip, regional, etc.). Most "Islamic funds" of this sort have had a consistent record of outperforming "the market" in most categories. This guide is intended to give general information on trends in Islamic banking and finance, and therefore, I refrain from giving any specific information on fund management firms.

One point which should be understood by the reader of this primer, however, is that a number of compromises were made by jurists to make it possible for "Islamic stock indices" and "Islamic mutual funds" to exist. If the strict *S̲harī'a* rules were applied, the pool of permitted stocks will be too small for any reasonable diversification to be possible. Here's a particular dilemma: the strict rules of *S̲harī'a* will dictate that the individuals (and hence the company in which they are shareholders) should neither borrow nor lend with interest. However, most listed companies fall in one of two categories: either they tend to face occasional liquidity shortages, in which case they borrow (with interest – of course), or they are cash-rich, in which case they tend to put their excess liquidity in interest-bearing instruments (e.g. government bonds, etc.). This, together with legal structures in the U.S. and elsewhere favoring debt financing (e.g. due to tax deductions on interest payments), make it very difficult to find companies which neither pay nor receive interest. This difficulty motivated the jurists' compromises discussed below.

S̲harī'ah boards are employed by "Islamic fund management" firms as

well as "Islamic index" generating companies. The jurists serving on those boards determine a set of rules for selecting the eligible pool of companies whose stocks may be held by Muslims. Some of those rules are clear-cut, while others require each investor to search his own conscience for answers. While the opinions of prominent jurists on "*S̲harī'ah* boards" add a significant measure of respectability and credibility to the enterprise, Muslims are ultimately responsible for their own decisions. If the reader finds some of those rules unconvincing, he or she should attempt to learn more by contacting the various firms and information sources. No matter how prominent the issuers of a *fatwā* may be, they are human. We ask Allāh to reward them for their best efforts, but we cannot absolve ourselves of our most basic religious responsibilities by following their opinions if we are convinced otherwise.

The first set of filters is straight-forward: exclude all companies whose primary business involves forbidden products (e.g. alcohol, pork, tobacco, financial services, weapon production, and "entertainment"). A typical screen given by the Dow Jones Islamic Index (DJII) *S̲harī'a* board can be found on the web at: http://www.dowjones.com/corp/index_products.htm (pp. 8-10). The second set of filters, based on "financial ratios", is significantly more dubious. The rules recently adopted by the DJII board are virtually identical with those adopted in earlier years by other fund management company *S̲harī'a* boards in Islamic countries. Those rules relate to the above mentioned compromises on three prohibitions due to the inherent *Ribā* and other impurities:

1. Carrying interest-bearing debt.

2. Receiving interest or other impure income.

3. Trading in debts at a price other than their face values.

The *S̲harī'a* boards of most Islamic fund managers and equity indices have reached very similar compromises. The following is the list of rules/compromises (ibid, p.10) used by DJII:

1. Exclude companies with a debt to total asset ratio of 33% or more.

2. Exclude companies with "impure plus non-operating interest income" to revenue ratio of 5% or more.

3. Exclude companies with accounts receivable to total assets ratio of 45% or more.

Those rules are virtually identical to those used by other indices, e.g. the FTSE Global Islamic Index Series, http://www.ftse.com/ebox/TII.html. The first compromise is based rather loosely on a famous *Ḥadīth* where Sa'd (mAbpwh) asked the Prophet (pbuh) how much of his wealth to give in charity, and the Prophet (pbuh) said: "one-third, and one-third is plenty" (اَلثُّلُثُ، وَ الثُّلُثُ كَثِيرٌ). This is clearly an out-of-context use of the Ḥadīth, and jurists do not claim that it is used as a legal proof, but rather as a comforting rule of thumb (لِلإِستِئنَاسِ، لَا لِلإِستِدلَالِ). The third compromise is based on the view that if the majority of the company's assets are illiquid, then the total assets may inherit the status of that majority (c.f. M. Taqi Usmani (1998, pp.208-210)). The second compromise assumes that 5% is a negligible amount. I have not been able to find any source which would mention the origin of that rule.

I do not have the pre-requisite religious knowledge to debate whether or not compromises on issues related to *Ribā* can be justified in this manner. However, I can point out that the cutoff-rules on financial ratios used in this area seem extremely arbitrary, and potentially rigid. In this regard, even if they are indeed justified, it is very unlikely that fixed cutoff ratios will be appropriate for all circumstances and all pools of equities! The reader will simply have to make his or her own mind. I cannot afford to bear any responsibility for others' decisions, and hope that the reader will recognize that I am only providing information on recent developments in this area to help him or her become better educated.

3.2 "Fixed income" funds

Many retirees and others need to invest in income generating vehicles with minimal risk. Obviously, investing in common stocks carries significantly more risk than most such people can tolerate. At the very least, a component of their investment needs to be earmarked for so-called "fixed-income" vehicles. Unfortunately, the vast majority of conventional fixed income investments (e.g. CDs, government bonds, money market accounts, etc.) include forbidden *Ribā*. How then can retirees and those nearing retirement be able to get a lower risk source of income from their investments?

Consider a simple example first: the individual seeking the lower risk investment vehicle may use his money to buy some real estate (e.g. an

apartment building, or a warehouse) that generate income in the form of rent. This rent will naturally go up with inflation, as will the value of the real estate, thus providing a reasonable inflation hedge and helping the investor keep the real value of his or her wealth, while generating an income on which to live.

Of course, any specific piece of real estate may still carry risks which the more sophisticated investor can diversify without affecting the average income stream. For instance, the particular area in which you buy an apartment building may become less fashionable, and the value of the building as well as the rent income may decline significantly. Also, any given building may require substantial repair costs due to unforeseen damages, etc. Therefore, it may be better for the investor to team-up with a group of similar-minded investors and jointly own a collection of buildings in different areas. Each individual's share of the total rent income will be equal to his share in the total value of the portfolio. This simple diversification can allow him to have the same average rent income he could get on his own, but with much lower risk (the chances that all the buildings will be adversely affected at the same time is very small).

This is the concept behind an "*'ijārah* fund". Recall that an Islamic financial institution engaged in a number of lease contracts continues to own the assets throughout the life of the leases. While some jurists restricted the lessor's ability to sell the leased asset or parts thereof during the lease period, most others permitted such a sale as long as the lease continues. Therefore, the Islamic financial institution can treat its portfolio of leased assets as a company or fund, shares of which may be sold to investors. The investors then earn a fixed income according to their shares in the fund. Like the forbidden conventional fixed income investments (e.g. money market funds, bonds, etc.), the fixed income from a lease fund will move up with inflation, and the risks borne are minimal (default in the conventional contract vs. default and repairs or losses of assets in the lease fund).[1]

[1]It is becoming popular nowadays to propose also having "*murābaḥa* funds" along similar lines. However, in a *murābaḥa*, the asset is no longer owned by the Islamic financial institution, and what they can "securitize" and sell is therefore the cash flow generated by the liability on the buyer. Such debts/liabilities may only be sold at par value, and therefore cannot provide a source of income for the "investors". Compromises along the lines discussed above are constantly cropping-up, with a higher percentage of physical assets being combined with some *murābaḥa* accounts receivables in a single portfolio.

Chapter 4

Permissible Insurance Alternatives

When thinking about reducing certain types of risk (one can never "eliminate" a risk in the sense of full "insurance"), one often thinks of "buying insurance". The typical financial insurance contract used in North America and elsewhere would entail signing a policy with an insurance company whereby the insured makes periodic premium payments, and the insurance company promises to compensate the insured for damages or part thereof according to a well-specified formula. The majority of Islamic jurists have concluded that this contract is invalid based on the prohibition of *Gharar*. Moreover, since many insurance contracts also include an investment component (e.g. certain types of term and life insurance), the insurance companies' investments in interest-bearing bonds render such contracts invalid based on the prohibition of *Ribā*.

The first thing to notice is that "buying insurance" is not the only method of risk reduction. We have already seen in the previous chapter how simple diversification schemes can reduce risks. As a matter of fact, the endorsed Islamic alternative to conventional insurance is the notion of cooperative or mutual insurance,[1] which is based precisely on the same logic of diversification used in that chapter.

[1] Jurists often use the Arabic term "*takāful*", which means cooperative mutual insurance, for this contract. However, since variations on this term have recently been "trademarked" in Europe and the U.S., I shall refrain from using it lest the reader assume that I am endorsing any particular institution to the exclusion of others.

4.1 Prohibition of financial insurance

Let us abstract from the prohibition based on *Ribā* for a second, and consider only the argument for prohibiting financial insurance based on the prohibition of *Gharar*. This prohibition, unlike the prohibition of *Ribā*, is relative. Al-Bājī Al-'Andalusī (n.d., vol.5, *ḥāshiyah*, under *bay'u al-Gharar*) states:

> His (pbuh) prohibition of *bay'u al-Gharar* renders such a sale defective. The meaning of *bay'u al-Gharar*, and Allāh knows best, refers to sales in which *Gharar* was the major component (*ghalaba 'alayhi*) until the sale is justifiably described as *bay'u al-Gharar*. This is the type of sale which is unanimously forbidden. On the other hand, minor (*yasīr*) *Gharar* does not render a sales contract defective, since no contract can be entirely free of *Gharar*. Thus, the [legal] scholars differ in determining which contracts are defective due to differences in opinion regarding the extent of *Gharar* inherent in each: sic. whether it is substantial and invalidates the contract, or minor and retains the contract's validity.

Taqiyyudīn Al-Subkī explicitly summarizes the opinions of earlier jurists thus (Al-Nawawī (continuation by Al-Subkī) (1995, vol. 9)):

> The scholars said that the criterion for invalidity of the contract based on *Gharar*, or its validity despite the existence of *Gharar*, is thus: if necessity dictates committing *Gharar* which cannot be avoided without incurring an excessive cost, or if the *Gharar* is trivial (*ḥaqīr*), the sale is rendered valid, otherwise it is rendered invalid.... Thus, the differences among scholars are based on this general principle, where some of them render a particular form of *Gharar* minor (*yasīr*) and inconsequential, while others render the same form consequential, and Allāh knows best.

'Ibn Taymiya (1998, vol. 4) makes the same point as follows:

> In this regard, the corrupting factor in *Gharar* is the fact that it leads to (*kawnuhu maṭiyyat*) dispute, hatred, and devouring others' wealth wrongfully. However, it is known that this corrupting factor would be overruled if it is opposed by a greater benefit (*al-maṣlaḥah al-rājiḥah*).

Thus, Al-Ḍarīr (1997, pp.44-51) lists four necessary conditions for *G̱harar* to invalidate a contract:

1. It must be major.

2. The potentially affected contract must be a commutative financial contract (this includes sales, but excludes gifts and charitable contributions, including "sharing" arrangements).

3. The *G̱harar* must affect the principal components of the contract (e.g. the price and object of sale, language of the contract, etc.).

4. That there is no need met by the contract containing *G̱harar* which cannot be met otherwise.

Many contemporary jurists, e.g. Al-Zuḥaylī (1997, vol.5, pp.3415-3431), have argued that commercial insurance satisfies all four conditions. This opinion dates back at least to 'Ibn 'Ābidīn (n.d., vol.3, p.273 onwards), who issued a *fatwā* forbidding marine insurance.[2] The *G̱harar*, it is argued, results from the fact that the premium (price) is paid, where what is being bought is not well defined. The proponents of this view say that the insured may pay one small premium and collect a large sum if he can make a legitimate claim, and he may pay many premia without ever collecting any sum of money. Notice that "security/insurance" itself is not a valid object of sale under Islamic jurisprudence. In commercial insurance, jurists argue:

1. The *G̱harar* is argued to be quite substantial, since the amount to be collected from the insurance company may vary between zero and a very large sum, depending on chance.

2. The commercial insurance contract is a sale contract, which is a commutative financial contract.

3. The *G̱harar* affects the object of sale, and therefore it is integral to the contract.

4. The cooperative insurance alternative can meet the needs that are met by commercial insurance.

[2] As we have seen, the origin of the term risk, *re-secare*, suggests that the origins of the analysis of risk and insurance lie in this area.

4.2 Cooperative insurance

In cooperative insurance, a group of subscribers contribute to a pool of funds. Whenever one of the members makes a legitimate claim (relative to the specific form of cooperative insurance to which they subscribed), they draw money out of the pool. In the meantime, the funds in the pool are invested in an Islamic manner, and without exposing the policy holders to any extra significant risk. Unclaimed profits are then distributed among the policy holders. Notice that Al-Zuḥaylī (1997, ibid.) argued that

> The difference between commercial and cooperative insurance is that the insurer in the former is not an institution separated from the insured. Moreover, the members of the insuring organization are not seeking to make profits, but only to reduce the losses which affect some of them. In contrast, the insurance in exchange for fixed installments is implemented by an insurer which is a profit-seeking corporation. Such profits are made at the expense of the insured...

In fact, this logic is exactly applicable to the distinction between mutual and stock insurance companies as they exist in the U.S. The logic inherent in the above quote (that stock insurance companies seek to make profits at the expense of policy holders, while mutuals provide better insurance) in fact agrees with our most sophisticated economic understanding of the structure and operations of such companies.[3]

Unfortunately, most of the "cooperative insurance" companies established in Islamic countries are in fact similar in ownership structure to stock insurance companies. In principle, however, a mutual insurance company which invests its funds in Islamically acceptable ways would satisfy all the conditions put forth by the jurists as a valid alternative to commercial insurance. While no Islamic cooperative insurance companies are currently operating in North America, some efforts are underway both in the U.S. and Canada to establish such organizations. Until such a time, Muslims may still reduce risks through direct diversification, and in the absence of permissible insurance alternatives, most jurists agree that the use of available insurance vehicles becomes temporarily permissible if needed or required by law.

[3] The economically-oriented reader may consult Mayers and Smith (1988), Smith and Stutzer (1995), and the references therein.

Chapter 5

Answers to Commonly Asked Questions

5.1 Trading in stocks

Q: Is trading in stocks permissible, or is it forbidden "speculation" or gambling?

A: There is a difference between speculation and gambling. Every trade involves speculation: the purchased goods may go up or down in price. As explained in Chapter 3, common shares in a company provide the holder a claim to some portion of that company's assets, and a corresponding claim to its profits. As long as the company's business and financial position are acceptable, there is no reason to believe that trading in the company's shares is not permissible.

Speculation in productive trade and investment creates value for society, and therefore cannot be equated to gambling. In pure gambling, money changes hands based on chance, without any underlying productive activity taking place. On the other hand, trading in the shares of companies, with potential profits derived from productive economic activities, allows capital flows to allocate investments as productively as possible. Of course, if a business's primary activity is deemed unproductive (e.g. a casino, or a beer brewery), then Muslims will not be permitted to own shares in that company since owning such shares constitutes an implicit participation in the business's activity.

There are a number of issues involved in determining which companies' shares are "permissible" for Muslims. Please refer to Chapter 3 for more details.

Q: How about "day trading"? Shouldn't Islamic investment be "long term" rather than "speculative"?

A: I repeat the above distinction between productive speculation which is at the very heart of all permitted (and encouraged) trading on the one hand, and forbidden gambling on the other. It is possible for careless individuals to approach the stock market as a gambling casino, but it is also possible for such individuals to use any other market in the same manner. Following a "buy low and sell high" strategy is at the heart of all profitable trading, including the caravan trades in which the Prophet (pbuh) participated. If a profitable opportunity presents itself sooner than anticipated, a good merchant or investor would be criticized for foregoing such profits. Whether or not speculation amounts to gambling depends on the intentions of the trader, and the nature of the traded goods.

Assuming that intentions are good, and the proper screening of securities is observed, we must now turn to the issue of whether "day trading", where the investor intends to liquidate all positions at the end of each day, is particularly close to gambling as compared to other investment strategies. There is no reason to believe that the term of the trading activities influences whether or not it is considered gambling. Tradition has it that 'Abdul-Raḥmān ibn 'Awf (mAbpwh) reached Madīnah without any wealth (having left it all in Makkah), went to the market with an axe, and returned at the end of the day with a small fortune. His abilities to amass wealth were legendary, but that did not reduce his religious status, as he was one of the s̱hūra group to nominate the Ḵhalīfah, and he was one of the ten companions of the Prophet (pbuh) to receive glad tidings of admission into paradise.

That being said, one must comment from the financial point of view that most day-trading is – for lack of a better term – stupid wasting of talent and wealth. While a few professional traders may be sufficiently skilled to make modest profits on average in day-trading, the vast majority of those who engage in this activity are amateurs attracted by irresponsible advertisement that over-emphasizes a few large profits

made by some lucky individuals. The fact of the matter is that for most day-traders, they lose money on average, with very few making large profits out of sheer luck of making the right trades at the right time. Approached in this manner, it is definitely gambling. Viewed as gambling, most individuals will have better odds at a Las Vegas casino. If day-trading is approached in this manner, it wastes the trader's time in non-productive activities relative to his or her main professional career, and wastes his or her wealth. While "day trading" per se may not be easily condemned as *ḥarām*, waste of time and talent certainly may be condemned thus.

5.2 Interest on bank deposits

Q: There have been some "*fatwās*" in recent years permitting bank interest. Can we collect interest on our bank deposits? If not, what can we do?

A: There have indeed been some such "*fatwās*", especially by Egyptian muftīs. However, the vast majority of jurists, today and in the past, disagree with those expressed opinions. Intellectual honesty dictates that we should present both the minority and the majority opinions. The most famous of the minority *fatwās*, that of Dr. Ṭanṭāwī, was characterized by the Federal Shariat Court of Pakistan in *Judgment on Interest (Ribā)*, Lahore Lawyers' Book Club, 1992, as the "solitary opinion of Shaykh Tantawi of Egypt". It is also worthwhile noting that the timing of this and later *fatwās* coincided with a political backlash against a series of financial scandals for Egyptian savings and loans operations that had characterized themselves as "Islamic". The politics behind those *fatwās* do not concern us in this guide. We care primarily about the religious merits of the minority opinion against the opinions of the majority of jurists around the world, including at Al-Azhar.

Dr. 'Abd-Al-Mun'im Al-Nimr, an ex-Minister of 'Awqāf in Egypt, wrote an article in *Al-'Ahrām* (June 1, 1989), in which he argued that the reason for the prohibition of *Ribā* (which he argued to be the harm caused to the debtor) does not apply to deposits with banks. Therefore, he argued, bank interest was not the forbidden *Ribā*. The past mufti̅ of Egypt, and current S̲hayk̲hu-Al-'Azhar, Dr. Muḥammad Sayyid Ṭanṭāwī, issued a fatwa (*Al-'Ahrām*, 12 July 1989; November 1989)

permitting certain forms of interest, and in a series of five fatwas in the same newspapers in May 1991, he permitted all banking interest. The current Egyptian *muftī*, Sh. Naṣr Farīd Wāṣil, reiterated this opinion in the U.A.E. daily paper *Al-Ittiḥād*, August 22, 1997: "I will give you a final and decisive ruling (*fatwā*)... So long as banks invest the money in permissible venues (*ḥalāl*), then the transaction is permissible (*ḥalāl*)... The issue is an investment from money. Otherwise, it is forbidden (*ḥarām*)... there is no such thing as an Islamic or non-Islamic bank. So let us stop this controversy about bank interest".

Those *fatwās* have been published, and ignoring or denying their existence is not the solution. We only point out that those new rulings contradict many earlier and contemporaneous ones. For instance, the 'Azhar's own Research Council ruled as follows in 1965:

> Interest on all types of loans is forbidden *Ribā*. There is no difference in this regard between so-called consumption and production loans. Moreover, *Ribā* is forbidden (*ḥarām*) in small as well as large quantities, whether it is effected through time deposits, demand (or checking) deposits, or any interest-bearing loan contract. All such dealings are among the forbidden *Ribā*.

Many similar rulings and *fatwās* forbidding banking interest have been issued by different Fiqh Councils around the world.[1] Moreover, earlier Muftīs of Egypt have ruled of the prohibition. Thus Sh. Jād Al-Ḥaqq 'Alī Jād Al-Ḥaqq, who served both as muftī and as S̲hayk̲hu-Al-'Azhar ruled in his book *Al-Fatāwā Al-'Islāmiyyah*:

> Depositing monies to collect a fixed rate of interest is forbidden in Islām, and borrowing with interest from government institutions or banks is forbidden *Ribā*.

In this regard, it has long been established that deposits (e.g. with a bank) become loans as soon as they are used by the recipient of the deposit. Thus, Jordanian civil law (item 889) stated: "if the deposited

[1] The Arabic reader is referred to the books of Dr. Muḥammad 'Alī Al-Sālūs, in which he lists many prohibiting *fatwās* and debunks the foundations of those recent permitting *fatwās* (e.g. Al-Sālūs (1998, vol.1)).

item was an amount of money or something which perishes by usage, and if the depositor allows the recipient to use the deposited items, then the contract is considered a loan contract". In loan contracts, any increase, as we have seen, is forbidden *Ribā*.

Therefore, the vast majority of jurists (including those of Al-'Azhar in Egypt) rule that bank deposits are loans, and that the interest incurred on them is forbidden *Ribā*. However, if the question is asked: "assume that the interest has already been accumulated, what would the Muslim do with it?". An answer was provided by The Islamic Fiqh Council in Makkah (19-20 Rajab 1406 A.H./1985 C.E.):

> All income collected through *Ribā* interest is forbidden property (مَال حَرَام), and the Muslim may not use it for any personal benefit. Such money must be spent on infrastructure projects such as schools, hospitals, etc. to benefit Muslims. Such spending is <u>not</u> considered charity (صَدَقَة), but it is a form of purification from the *ḥarām* component. It is not permitted for the Muslim to leave the interest monies with the bank, since that would benefit the banks, especially if they are non-Muslim and foreign banks that may use such funds against Islam and Muslims directly or indirectly. This is being said with the full understanding that continuing dealings with *Ribā*-based banks, with or without interest, is not permitted.

This same opinion was given earlier by the Fatwā Committee of Al-'Azhar in the 1960s with regards to deposits with foreign banks which were necessary to facilitate international trade.

5.3 Lending

Q: If I lend someone $10 for 10 years, how can it be fair for him to return to me the same $10 when that amount of money buys a lot less than it did 10 years earlier?

A: There is a continued fundamental misunderstanding among many Muslims about the legal status of loans in Islamic Jurisprudence. This

confusion gives rise to questions regarding how to deal with inflation, and to faulty suggestions for how to build an Islamic banking system on "interest free loans".

Lending in Islam is a charitable contract, which differs from sales contracts in three fundamental ways (c.f. Al-Qarāfī, *Al-Furūq*, beginning of vol.4)

1. Loans may be conducted with *ribawī* goods (those measured by weight or volume for the Hanafīs, monetary numeraires and foodstuffs for the Mālikīs, S̱hāfi'īs, and Ḥanbalīs). Since a *ribawī* good is exchanged for an equal amount of that *ribawī* good in a loan, this would constitute "*Ribā al-nasā*" Thus, this is permitted in loans but forbidden in sales.
2. For non-*ribawī* goods, a loan may result in exchanging a known good for an unknown compensation later to be accepted. This is forbidden in sales but permitted in loans.
3. For a loan of fungibles, the equivalent sale would include the forbidden sale of what one does not have. However, this third rule is also relaxed for loans.

Al-Qarāfī proceeds to explain that those rules are relaxed in loans since the loan is primarily a charitable contract. According to Al-S̱hīrazī in *Al-Muhadẖdẖab* (vol.1), and Ibn Qudāmah in *Al-Mug̱hnī* (vol.4, p.313), it is narrated that 'Abu Al-Dardā' (mAbpwh) said: "I prefer to lend two Dinārs, get them back, and lend them out again, to giving them away in charity", and Ibn Mas'ūd and Ibn 'Abbās are narrated to have said "two loans are better than one charitable payment".

Another fundamental difference between lending and financing methods is that the lender has the right to request repayment of the loan at any point in time. If the debtor is capable of paying, he must do so (ibid). Therefore, any form of loan, "interest free" or otherwise, is unsuitable as a basis for any form of finance!

Therefore, the loan contract is a form of charity since the lender is giving away the usufruct of the lent money or goods for the period of the loan. This charitable contribution includes the "time value" of that money or good. If that time value is higher due to inflation, then the lender has given a larger charity. Notice that if the debtor cannot pay

(as per the verses of *Ribā* in *Sūrat Al-Baqarah* [2]), the creditor must give him extensions until he is able. In fact the debtor may never be able to pay back, in which case the entire lent sum is considered charity.

In a recent ruling, the Fiqh Academy of the Organization of the Islamic Conference, in a Seminar on indexation held in Bahrain (September 22-23, 1999) distinguished between two cases: whether or not the inflation was anticipated. If the inflation was anticipated, then the reduced purchasing power of the lent money was indeed paid charity, and the lender may not demand any compensation. In the case where the inflation was not anticipated, the Academy recommended resorting to arbitration. If arbitration was not possible, the Academy devised rules of compensation depending on whether the loss due to inflation was major (over 33%) or minor (less than 33%). The arbitrariness of this rule is quite apparent, especially since this rule could not possibly be adequate independently of the term of the loan!

Most interesting, however, is the fact that the Academy categorically ruled out as strictly forbidden the commonly-suggested solution of indexation of a lent amount of money to cost of living, interest rates, GNP growth rates, the price of gold or some other commodity, etc. Of course, that opinion by the Academy does not rule out the possibility of lending gold instead of dollars, if the latter indexation was desired.

The best way to summarize the status of lending and *Ribā* in Islam is this:

> In Islam, one does not lend to make money, and one does not borrow to finance business.[2]

Loans are a charitable contract, and therefore if inflation causes the lender to lose more than he anticipated (with or without the OIC Fiqh Academy's compensation scheme), then the charitable part of the loan is larger. Demanding compensation for such an increase in charity would be unwise and insolent in Islam, since only Allāh can and will determine the appropriate reward. If the purpose of extending the

[2]Of course, the second part of this slogan is not based on a religious prohibition. However, since the lender is not entitled to any part of the profits of the investor, he would only be exposed to the negative possibility of losses without a corresponding potential for gains. This is not a good or sustainable way to finance business.

loan was making profits or engaging in a business project, then the parties should not have selected the loan contract as the vehicle for such transactions. Please review Chapter 2 for a summary of appropriate contracts that are intended for such purposes.

5.4 What is the difference?

Q: It seems to me that all you're doing is re-labeling interest as "rent" or "profit", but dollar-for-dollar, I don't see any difference between what you call an Islamic contract and what is done by banks and mortgage companies.

A: Islamic law puts many restrictions on contracts to attain maximal justice in financial transaction, minimize the potential for legal disputes, and build a healthy and stable financial and economic system. Of course, all those goals are shared by secular governments as well, and they utilize their best human effort to attain them. The fact that there is a great deal of similarity between the two systems should therefore come as no surprise. To draw an analogy, many rational non-Muslims share the Muslims' recognition of the evils of intoxicants and drugs, and attempt to avoid them in the same manner.

The fundamental difference from a legal point of view is the central role of Revelation in Islamic Law. Islamic jurists, like legal experts of other system, exercised and continue to exercise their best judgment in light of the extant body of Islamic Law. The main difference is the general rule: "no ruling based on legal reasoning is allowed where a ruling exists in a Legal Text (*Naṣṣ*) [in the Qur'ān or Ḥadīt̲h̲]" (لَا اجتِهَادَ فِيمَا فِيهِ نَصّ). Therefore, the fine legal distinctions between Islamic jurisprudence and man-made laws will normally be based on the existence of a Canonical Legal Text (*Naṣṣ*).

Obviously, the great Islamic legal scholars of the past rarely, if ever, wrote extensive discussions to justify legal injunctions that are directly derivable from a *Naṣṣ*. Such justification would not change the applicability of the law, and may be harmful if later proven wrong.[3]

[3] A case in point is the wrong justification of the prohibition of *ribā* purely on the grounds of preventing exploitation. See footnote 1 of Ch. 1 for a reference.

On the other hand, we have very few glimpses of the legal understanding of those scholars when they discussed how to generalize the implications of a Legal *Naṣṣ*. One very illuminating instance is provided by 'Ibn Rus̱hd (1997, vol.3,pp.183-184). When discussing the different generalizations of the prohibition of *ribā* in the six commodities (gold, silver, dates, wheat, barley, salt) mentioned in the first referenced Ḥadīt̲h̲, 'Ibn Rus̱hd reasoned as follows:

> "It is thus apparent from the law that what is intended by the prohibition of *Ribā* is what it contains of excessive injustice (*g̱hubn fāḥis̱h*). In this regard, justice in transactions is achieved by approaching equality. Since the attainment of such equality in items of different kinds is difficult, their values are determined instead in monetary terms (*with the Dirham and the Dīnār*). For things which are not measured by weight and volume, justice can be determined by means of proportionality. I mean, the ratio between the value of one item to its kind should be equal to the ratio of the value of the other item to its kind. For example, if a person sells a horse in exchange for clothes, justice is attained by making the ratio of the price of the horse to other horses the same as the ratio of the price of the clothes [for which it is traded, tr.] to other clothes. Thus, if the value of the horse is fifty, the value of the clothes should be fifty. [If each piece of clothing's value is five], then the horse should be exchanged for 10 pieces of clothing.
>
> "As for [fungible] goods measured by volume or weight, they are relatively homogenous, and thus have similar benefits [utilities]. Since it is not necessary for a person owning one type of those goods to exchange it for the exact same type, justice in this case is achieved by equating volume or weight since the benefits [utilities] are very similar..."

This quote cannot be treated fully in this short guide.[4] However, the reader can immediately see one major difference between the finance

[4]For a fuller economic analysis, see my paper "An Economic Explication of the Prohibition of *Ribā* in Classical Islamic Jurisprudence", available on the web at `http://www.ruf.rice.edu/~elgamal/riba.pdf`.

payments in an Islamic contract and those in a *Ribā*-based contract.

The "equality" of compensations, which 'Ibn Rus̲hd lists as the fundamental reason for prohibiting *Ribā*, guarantees a certain degree of **marking to market** in an Islamic financial contract. For instance, if a home purchase is financed through an Islamic lease-purchase or diminishing partnership, there is a "rental" payment in place of the "interest" payment in a conventional mortgage. This distinction is not simply verbal window-dressing. The going market rent for similar properties in similar areas can be used as a benchmark to gauge the appropriate financing charges.

Of course, as we have seen previously, the interest payments in a conventional mortgage may just happen to be exactly equal to the rent component in an Islamic contract. Even if the conventional mortgage contract had agreed with all the other Islamic *'ijārah* or *s̲harika* requirements enumerated by the jurists (it does not!) this would not mean that using the latter is mere window dressing. The Islamic contract forces the two parties to link the finance charges to a specific tangible asset, and thus forces comparison (if not equalization) with the time value of money invested in that asset.[5] It also enforces all the other legal conditions associated with the lease-purchase or declining partnership contract.

The fundamental difference between the two cases cannot be overemphasized. From a religious point of view, writing a contract that intentionally abides by Islamic Legal injunctions is very different from writing one which does so by mere coincidence or based on human reasoning. Moreover, from a legal and practical point of view, the first contract is guaranteed to continue to abide by Islamic Law, while the latter may change with circumstances. Such change can impose a significant cost on the Muslim who has to seek refinancing to abandon *Ribā* and live in accordance with the *S̲harī'a*.

[5]Those educated in contemporary economics and finance will recognize the importance of this rule in effecting desirable economic efficiency and fairness.

Appendix A

Translation & transliteration

For the benefit of the reader, I have included three tables in this appendix to simplify the reading of transliterated terms throughout the text. The second table shows the standard Library of Congress transliteration key which I used in this document. The third table provides the reader with a handy glossary of terms which I have used often in this document, and which are commonly used in the language of Islamic banking and finance.

A.1 Abbreviations

Abbreviation	**Full phrase**	**Corresponding Arabic**
swt	Transcendent is He	سُبحَانَهُ وَ تَعَالَى
pbuh	peace be upon him	صَلَّى اللّٰهُ عَلَيهِ وَ سَلَّم ṣallā Allāhu ‘alayhi wa sallam
mAbpwh	may Allāh be pleased with him (her)	رَضِيَ اللّٰهُ عَنهُ (عَنهَا) raḍiya Allāhu ‘anhu (‘anhā)
mAbpwt	may Allāh be pleased with them	رَضِيَ اللّٰهُ عَنهُم (عَنهُمَا) raḍiya Allāhu ‘anhum (‘anhumā)

A.2 Transliteration table:

Transliteration	**Arabic letter**	**letter name**
Short vowels illustrated with consonant "b"		
ba, bi, bu	بَ، بِ، بُ	fatḥa, kasra, ḍamma
Long vowels illustrated with consonant "b"		
bā, bī, bū	(بَا، بَى) ، بِي، بُو	'alef, yā', wāw
Consonants		
'a, 'i, 'u	أَ، إِ، أُ	hamza
b	ب	bā'
t	ت، ة	tā', tā' marbūṭa
t̲h̲	ث	t̲h̲ā'
j	ج	jīm
ḥ	ح	ḥā'
k̲h̲	خ	k̲h̲ā'
d	د	dāl
d̲h̲	ذ	d̲h̲āl
r	ر	rā'
z	ز	zāy
s	س	sīn
s̲h̲	ش	s̲h̲īn
ṣ	ص	ṣād
ḍ	ض	ḍād
ṭ	ط	ṭā'
ẓ	ظ	ẓā'
'	ع	'ayn
g̲h̲	غ	g̲h̲ayn
f	ف	fā'
q	ق	qāf
k	ك	kāf
l	ل	lām
m	م	mīm
n	ن	nūn
h	ه	hā'
w	و	wāw
y	ي	yā'

A.3 Glossary of used Arabic terms

Transliteration	Translation	Arabic
Sharīʿah	The Islamic Way/Law	شَرِيعَة
ʿaqd	contract	عَقد
ʾījāb	offer	إِيجَاب
qabūl	acceptance	قَبُول
thaman	price	ثَمَن
wakīl	legal proxy; agent	وَكِيل
ʿaqd bāṭil	invalid contract	عَقد بَاطِل
ribā	usury	رِبَا
Gharar	risk and uncertainty	غَرَر
murābaḥa	cost-plus sale	مُرَابَحَة
dayn	debt or libability	دَين
bayʿ bi-thaman ʾājil	credit sale	بَيع بِثَمَن آجِل
ʾijāra	lease	إِجَارَة
ṣarf	currency exchange	صَرف
salam	Islamic forward sale	سَلَم
ʾistiṣnāʿ	commission to manufacture	إِستِصنَاع
muḍāraba	silent partnership	مُضَارَبَة
mushāraka	partnership	مُشَارَكَة
faqīh, fuqahāʾ	jurist, jurists	فَقِيه ، فُقَهَاء
ʾijmāʿ	consensus	إِجمَاع
qiyās	inference by analogy	قِيَاس
fatwā (pl. fatāwā)	Islamic legal opinion(s)	فَتوَى (ج. فَتَاوَى)
madhhab (pl. madhāhib)	school(s) of jurisprudence	مَذهَب (ج. مَذَاهِب)
ḥalāl	permissible	حَلَال
ḥarām	prohibited	حَرَام
ḥiyal	contemptible legal tricks	حِيَل

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Some information on the Internet

This is a partial list of some of the general information websites that focus on issues in Islamic Banking and Finance. This list excludes many excellent sites developed by providers of Islamic financial services. The reader can find those sites linked to the ones listed here, or by using a web search engine. I do not vouch for the accuracy of all the information on those sites. This list is not exhaustive. It is provided to give the reader a starting point for searching the web for more information on the subject.

- http://www.muslim-investor.com
- http://www.islamiQ.com
- http://www.hifip.harvard.edu
- http://www.irti.org
- http://www.islamic-banking.com
- http://islamic-finance.net
- http://www.muslimsonline.com/ief